monitor REPRINTED FROM THE 2012 SEP/OCT ISSUE, VOL. 39, NO. 6

Caveat Lessor: Lessons Learned From the Dewey & LeBoeuf Collapse

BY JEFFREY A. WURST, ESQ. AND BERTRAND CHOE, ESQ.

When law firm Dewey & LeBoeuf filed for Chapter 11 protection, it was obligated to its equipment lessors (including Winthrop Resources, U.S. Bank Equipment Finance and SunTrust) in an amount in excess of $45 million. Jeffrey Wurst and Bertrand Choe explain what led to Dewey's collapse and offer advice regarding key indicators of a potential lessee's fiscal irresponsibility.

JEFFREY A. WURST, ESQ.
Senior Partner, Ruskin Moscou Faltischek, P.C.

BERTRAND CHOE, ESQ.
Associate, Ruskin Moscou Faltischek, P.C.

Victims of bankruptcy come in many forms. They include the debtors themselves, as well as their secured and unsecured creditors. When professional service companies fall into bankruptcy, leasing companies are among the hardest hit. Typically, when a company leases equipment, the value of that equipment drops faster than the income generated from lease payments. Thus, during the earlier periods of the lease, the leasing company is at its greatest risk of incurring losses.

During the past four years alone, a mere sampling of the list of law firm and professional service companies that have declared bankruptcy includes Howrey LLP, Thelen LLP, Heller Ehrman LLP, Dreier LLP, PMI Group, MF Global and Lehman Brothers Holdings Inc. The most recent, and the largest, law firm to file for Chapter 11 protection is Dewey & LeBoeuf LLP.

After more than half of its partners defected and after failed attempts at a merger, on May 29, 2012, Dewey filed for bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York. Many theories abound as to the cause(s) of Dewey's collapse but essentially, the crux appears to be that Dewey guaranteed an unsustainable amount of compensation to both newly acquired and long-

When professional service companies fall into bankruptcy, leasing companies are among the hardest hit. Typically, when a company leases equipment, the value of that equipment drops faster than the income generated from lease payments.

SINGLE USE ONLY

©2012 Xander Media Group, Inc. *Monitor* is an Xander Media Group (XMG) publication. The views and opinions expressed in this publication throughout editorial and advertisements are not necessarily those of XMG management. All rights reserved. **Reproduction, duplication or redistribution in whole or in part is not permitted without express written permission of the publisher.**

standing partners. Dewey subsequently took on debt, which coincided with the recent recession. Further exacerbating Dewey's collapse was an enormous divide in salary between senior and junior lawyers, with the ratio of salaries being reported at between 12:1 and 15:1. Then, as Dewey's facade showed cracks, partner defections (along with their clients) resulted in even less revenue for the firm.

Dewey & LeBoeuf was the product of a merger between firms Dewey Ballantine and LeBoeuf, Lamb, Greene & MacRae in 2007. Legacy Dewey was struggling at the time, with its net income plummeting by $80 million in one year. In that same time, legacy LeBoeuf's net income rose by over $100 million. Still, legacy Dewey offered its prestigious name, and both firms believed that a larger firm was required to compete in the legal market. What legacy LeBoeuf did not know, apparently, was that legacy Dewey had not just been losing profits, but was in debt.

Almost immediately, Dewey & LeBoeuf poached lawyers from other firms, offering *guaranteed* long-term contracts at high salaries. Several partners were even given packages of more than $5 million annually. In the fall of 2011, Steven Davis, Dewey's former chairman, revealed that almost 100 lawyers had been given guarantees. However, incoming revenue was not enough to satisfy the exorbitant salaries. In fact, since the creation of Dewey & LeBoeuf, partner distributions always far exceeded net income. Furthermore, contributions to pension plans were deferred to future years.

In March 2010, Dewey raised $125 million in a private bond offering, an extremely rare course of action for a law firm. However, the offering contained no "risk factors," which in hindsight should have served as a red flag. In fact, it turns out that Dewey failed to

SINGLE USE ONLY

©2012 Xander Media Group, Inc. *Monitor* is an Xander Media Group (XMG) publication. The views and opinions expressed in this publication throughout editorial and advertisements are not necessarily those of XMG management.
All rights reserved. **Reproduction, duplication or redistribution in whole or in part is not permitted without express written permission of the publisher.**

monitor REPRINTED FROM THE 2012 SEP/OCT ISSUE, VOL. 39, NO. 6

disclose the guarantees to partners in its offering.

Dewey's books were not much better. Dewey reported its annual revenue to American Lawyer Media by totaling the year's cash receipts plus outstanding accounts receivable at the year end. The next year, collection of the accounts receivable was then attributed to the cash receipts, thus double-counting these amounts.

When Dewey filed for Chapter 11 protection it was obligated to its equipment lessors (including Winthrop Resources, U.S. Bank Equipment Finance and SunTrust) in an amount in excess of $45 million — an extraordinary amount in light of the assets available to recover against.

The case of Dreier LLP had several similarities with Dewey. Dreier, like Dewey, enticed lawyers with lavish compensation packages. Some attorneys were paid more than $25,000 per week. Furthermore, despite expanding, Dreier still operated at a net loss at about $1 million *per month*. Unlike Dewey, however, Dreier had only one equity partner that conducted all financial and administrative functions. As a result, Dreier's books were more opaque than those of Dewey.

When Dreier filed for bankruptcy in 2008, the firm's schedules showed several equipment lessors as unsecured creditors, including Canon Business Solutions-East and Canon Financial Services, Inc. One week after filing its schedules, Dreier moved to reject its equipment leases with Canon, which motion was granted unopposed, leaving Canon with a general unsecured claim deemed to have accrued before the petition date.[1] Canon Business filed two proofs of claim for $28,237.88 and $18,168.78, while Canon Financial filed a proof of claim for $416,606.22. To add insult to injury, Dreier then brought a preference action seeking to recover over $25,000 from Canon Business.

The vast majority of leases Dreier entered into with Canon Financial were 36-month leases entered into in 2008, a few months before Dreier entered into bankruptcy. Despite the short amount of time between leasing the equipment and the petition date, the equipment lost much of its value as soon as it was installed at Dreier's offices. Thus, the return of Canon's equipment failed miserably to come close to the worth of the remainder of the lease, contributing to almost a half million dollars in claims. The Dreier bankruptcy has yet to come to a close, but a return of pennies on the dollars for Canon and other equipment lessors is almost inevitable.

It goes without saying that equipment lessors should avoid dealing with law firms and professional service companies that exhibit red flags for an imminent bankruptcy. However, an equipment lessor's due diligence should not stop after the lease is entered into; instead, the lessor should monitor the lessee throughout the life of the lease. If Dewey's bankruptcy has taught us anything, it is that there are certain indicators of fiscal irresponsibility. Watch for: 1.) deferred returns of capital to partners; 2.) reallocation of income in the company; 3.) unusually high lines of credit; 4.) wide disparities in pay amongst the professionals; 5.) deferred contributions to p ension plans; and 6.) any attempts to creatively define net income. Of course, it is difficult to predict whether a company or law firm will go bankrupt. Exercising sound credit judgment prior to extending the leasing facility, however, will mitigate these kinds of risks.

1 See 11 U.S.C. §365(g).

It goes without saying that equipment lessors should avoid dealing with law firms and professional service companies that exhibit red flags for an imminent bankruptcy. However, an equipment lessor's due diligence should not stop after the lease is entered into; instead, the lessor should monitor the lessee throughout the life of the lease.

JEFFREY A. WURST is a partner at Ruskin Moscou Faltischek, P.C. in Uniondale, NY, where he chairs the firm's Financial Services, Banking and Bankruptcy Department. **BERTRAND CHOE** is an associate in that department.

SINGLE USE ONLY

©2012 Xander Media Group, Inc. *Monitor* is an Xander Media Group (XMG) publication. The views and opinions expressed in this publication throughout editorial and advertisements are not necessarily those of XMG management. All rights reserved. **Reproduction, duplication or redistribution in whole or in part is not permitted without express written permission of the publisher.**